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Here's A Radical Idea: Fiscal Responsibility

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When San Diego Mayor Jerry Sanders recently proposed creating a defined contribution plan for the financially troubled city's new municipal employees, the response was predictable.

Lorena Gonzalez, head of the San Diego-Imperial Counties Labor Council, warned that the stock market would inevitably crash, wiping out the value of retired workers' investment accounts. "I guess Mayor Sanders would simply let them live on cat food," she moaned.

Marcia Fritz, president of the California Foundation for Fiscal Responsibility, was not quite as scathing. The advocate of public pension plan reform did, however, point to bad outcomes for public employees in selected states that substituted 401(k)-style retirement packages for traditional defined benefit plans. Fritz urged the city instead to consider a proposal by San Diego Councilman Carl DeMaio to contain pension costs by preventing abuses of the rules for calculating pension benefits.

Actually, DeMaio called Mayor Sanders's proposal a good first step. Nobody suggested that it would solve the problem of liabilities already created under the city's existing pension plan. On the other hand, instituting a defined contribution plan could save San Diego from creating a future fiscal nightmare. That ought to appeal to residents of a city dubbed "Enron by the Sea" for its financial finagling. The Securities and Exchange Commission charged past municipal officials with fraudulently failing to make adequate disclosures about the city's underfunded pension plan.

In a defined benefit plan, the employer promises workers a specified level of income upon retirement. To make sure that the dollars will be there when the employees retire, the employer invests amounts that will be cover the future costs, based on an assumed rate of return. It is understandable why workers like this arrangement: They bear no risk that the investments will perform poorly.

Naturally, the risk does not magically disappear. In the case of a state or city retirement plan, it is the taxpayers who must cough up the difference if the pension plan's investment returns fall short. An even bigger risk for taxpayers is that elected officials will assume unrealistically high returns to rationalize skimping on contributions to the fund. That is a popular way to balance the budget in the short term and guarantee a fiscal crisis in the long term.

The alternative proposed by Sanders is to require the city to provide employees cash, rather than promises. They would then invest the money in a well-vetted selection of mutual funds. Neither workers nor taxpayers would be exposed to the risk of fiscal irresponsibility on the part of politicians.

Could arrangements similar to 401(k) plans, which have become standard in the private sector, leave government workers with less wealth than they need for retirement? Yes, but let us consider under what circumstances that would likely happen. One is if employees ignore the guidelines for prudent investing they receive as part of the plan administration.

In another scenario, investors act responsibly but still come up short. They invest in well-conceived mixtures of stocks and bonds so as to benefit from economic growth while also preserving capital. As they approach retirement they increase the bond allocation, as a safeguard against the stock market crashing just before they need the money.

If this plan fails to provide a satisfactory return over four decades between entering the work force and retiring, it will be because the U.S. economy goes into a long-term funk. In that case, workers still "fortunate" enough to participate in defined benefit plans will be no better off than their peers in defined contribution plans. The country will not be able to afford to make good on the promises of all the defined benefit plans that experienced inadequate investment returns. Most likely, the federal government will solve the problem through inflation. The pension benefits will be paid in nominal terms but in real terms retirees will not be able to make ends meet.

San Diego Mayor Sanders calls his defined contribution proposal a “radical idea.” In reality, it is the only sensible way to prevent state and local governments from being financially ruined over and over again by the cost of public employee pension benefits. Politicians cannot be trusted to resist the temptation of balancing the budget by underfunding defined benefit plans.